

Before The  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

In The Matter of

Treatment of Local Exchange Carrier  
Tariffs Implementing Statement of  
Financial Accounting Standards,  
"Employers' Accounting for  
Postretirement Benefits Other Than  
Pensions"

Bell Atlantic Tariff F.C.C. No. 1

US West Communications, Inc. Tariff  
F.C.C. Nos. 1 and 4

Pacific Bell Tariff F.C.C. No. 128

CC Docket No. 92-101

Transmittal No. 497

Transmittal No. 246

Transmittal No. 1579

REPLY COMMENTS OF THE  
NYNEX TELEPHONE COMPANIES

New England Telephone and  
Telegraph Company

and

New York Telephone Company

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## SUMMARY

As shown in the NYNEX Telephone Companies' Direct Case, and notwithstanding our opponents' arguments, the FCC should grant an exogenous change to price cap index levels to permit recovery of the incremental costs of implementing SFAS 106.<sup>1</sup> Under SFAS 106, effective January 1, 1993, the NTCs are required by the FCC to reflect accrual instead of pay-as-you-go accounting for OPEB expenses on their regulated books. While AT&T does not oppose exogenous recovery in principle, the three other opposition parties argue against recovery.

The NTCs show in these Reply Comments that, first, implementing SFAS 106 results in a exogenous change under the Commission's price cap rules. We have met the standard that the FCC has specifically set forth for exogenous treatment of a change in GAAP, the type of change involved here. That is, exogenous treatment of the additional costs from implementing SFAS 106 should be afforded to the extent there is no double-counting of recovery through the price cap/GNP-PI mechanism. The price cap LECs need not demonstrate a lack of control over the OPEBs themselves, just the underlying accounting change, as they clearly have done. Further, exogenous treatment will be consistent with, and indeed advance, the FCC's price cap policies. We will continue to have strong incentives to be more efficient and productive, and the price cap risk/reward balance will be maintained.

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<sup>1</sup> Abbreviations herein are referenced in the text.

Second, the SFAS 106 implementation costs for exogenous recovery are not double-counted under price caps. As the Godwins initial study and supplemental report soundly demonstrate, about 84.8% of the additional costs from the SFAS 106 OPEB accounting change will be unrecovered absent exogenous treatment. Further, despite several parties' specious contentions, there is no double-counting of SFAS 106 implementation costs in the rate of return prescription incorporated in initial price cap rates.

Finally, our opponents' arguments to limit SFAS 106 rate recognition are artificial and should be dismissed.

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REPLY COMMENTS OF THE  
NYNEX TELEPHONE COMPANIES

I. INTRODUCTION AND OVERVIEW

New England Telephone and Telegraph Company and New York Telephone Company (the NYNEX Telephone Companies or NTCs) submit these Reply Comments to Oppositions filed July 1, 1992, by AT&T, Ad Hoc,<sup>2</sup> ICA<sup>3</sup> and MCI in the above-captioned proceeding. Those Oppositions address the Direct Cases filed June 1, 1992, by the NYNEX Telephone Companies, other price cap LECs<sup>4</sup> and USTA<sup>5</sup>, pursuant to the Order of Investigation and

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<sup>2</sup> Ad Hoc Telecommunications Users Committee.

<sup>3</sup> International Communications Association.

<sup>4</sup> Local Exchange Carriers.

<sup>5</sup> United States Telephone Association.

Suspension (OIS) released April 30, 1992, by the Chief, FCC Common Carrier Bureau.

As demonstrated in our Direct Case and notwithstanding our opponents' arguments, the Commission should grant the NTCs an exogenous change to price cap index levels to recover the additional costs arising from implementation of Statement of Financial Accounting Standards No. 106 (SFAS 106) -- Employers' Accounting for Postretirement Benefits Other Than Pensions (OPEBs). Basically, AT&T would allow a certain level of exogenous recovery, but the other three opposition parties oppose any recovery. We show herein that: these parties misstate the applicable standard under price caps for exogenous treatment of a change in Generally Accepted Accounting Principles (GAAP) -- the type of change involved here; exogenous treatment of the OPEB accounting change will advance the Commission's price cap policies; about 84.8% of the NTCs' additional costs from this accounting change will be unrecovered (as demonstrated by Godwins<sup>6</sup>); there is no double-counting of OPEB costs in the FCC-prescribed rate of return; and our opponents' proposed limitations on exogenous cost recovery (through mandating uniform assumptions, prefunding requirements, etc.) are unsound.

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<sup>6</sup> See Godwins initial study appended to our Direct Case, and Godwins Supplemental Report, attached hereto.

## II. IMPLEMENTING SFAS 106 RESULTS IN AN EXOGENOUS COST CHANGE UNDER THE FCC'S PRICE CAP RULES

### A. Our Opponents Misstate The Applicable Price Cap Standard For Exogenous Treatment

Our Direct Case (pp. 6-8) sets out the FCC's rules and pronouncements which make clear that exogenous treatment of the incremental costs from implementation of mandated SFAS 106 regulatory accounting should be granted to the extent there is no double-counting of recovery through the price cap/GNP-PI mechanism. Basically, GAAP changes are already listed in the FCC's rules (under USOA<sup>7</sup> changes in Rule 61.45(d)(ii)) as eligible for exogenous treatment. The FCC has emphasized that:

"The accounting change AT&T seeks to claim as exogenous [SFAS 106] will probably be mandated by FASB in 1992, and at that time qualify for exogenous treatment.... [E]xogenous costs [associated with USOA changes] can be either cost changes resulting from a change in [FCC] accounting rules or in any Commission-approved change in GAAP."<sup>8</sup>

While AT&T accurately sets forth (pp. 5-6) the Commission's established standard, Ad Hoc improperly seeks to distort and expand that standard (pp. 5-18).<sup>9</sup> Ad Hoc

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<sup>7</sup> Uniform System Of Accounts.

<sup>8</sup> AT&T, Transmittal No. 2304, Order by Chief, Common Carrier Bureau released June 27, 1990 (DA 90-878), para. 4. See also CC Docket No. 87-313, LEC Price Cap Order, released October 4, 1990, 5 FCC Rcd 7664, para. 168; LEC Price Cap Reconsideration Order, released April 17, 1991, 6 FCC Rcd 2637, paras. 59, 63; AT&T Price Cap Reconsideration Order, released February 8, 1991, 6 FCC Rcd 665, para. 75; OIS para. 6.

<sup>9</sup> In an attempt to support its position, Ad Hoc appends a report prepared by Economic and Technology, Inc., entitled Analysis of FAS 106 Effects Under Price Caps (ETI Report). That same report is submitted by ICA.

mistakenly states that (pp. 6-7) changes in GAAP, such as the adoption of SFAS 106 by the Financial Accounting Standards Board (FASB), are not listed as presumptively exogenous items in Rule 61.45(d), and therefore special "difficult hurdles" apply. As indicated above, USOA changes are listed in Rule 61.45(d) and the Commission has held that FCC-required GAAP changes are treated under the same standard as USOA changes.

Ad Hoc also incorrectly maintains that (p. 8) LECs must demonstrate a lack of control over the OPEBs themselves to justify exogenous treatment.<sup>10</sup> LECs need only demonstrate that they had no control over the mandated regulatory accounting change. That change is the exogenous event here, not the underlying benefits. As we indicated,<sup>11</sup> the NTCs are required by FCC rules and orders to implement SFAS 106 for regulatory accounting purposes no later than January 1, 1993. Therefore, this GAAP change is clearly beyond our control<sup>12</sup> and warrants exogenous treatment to the extent there is no double-counting, as discussed herein.

Ad Hoc also wrongly asserts that (pp. 10-11) the price cap LECs must show that absent exogenous treatment of SFAS 106, "confiscation" would occur. Ad Hoc cites to the LEC Price Cap Order (para. 190) and to a Southwestern Bell Telephone Company

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<sup>10</sup> See also MCI 8.

<sup>11</sup> NTCs Direct Case 2-5.

<sup>12</sup> See MCI 8 ("lack of control over the FASB ruling is apparent....")



Order,<sup>13</sup> but these citations are unavailing. In the cited portion of the LEC Price Cap Order, the Commission stated:

"Nevertheless, consistent with the Constitutional ban on confiscatory rates, we leave open the possibility that in a truly extraordinary situation, we would approve above cap rates, even perhaps without suspension and investigation."

This Commission's statement was in reference to LECs' request that "all extraordinary costs should automatically be granted exogenous treatment." However, the present issue involves a GAAP change which the FCC has specifically held is eligible for exogenous treatment once FASB has approved it and the change has become effective in regulatory accounting. The present issue does not involve "extraordinary exogenous cost changes" as referenced in Rule 61.45(d)(vi). To obtain exogenous treatment of a GAAP change, there is no requirement that a carrier demonstrate its rates would be confiscatory without allowance for exogenous treatment.

The Southwestern Bell Order cited by Ad Hoc concerned that RBOC's request to increase its access tariff rates to be used for price cap purposes in the first six months of 1991. In that context, the FCC was referring to an "extraordinary cost" not on the specific list of presumptively allowed exogenous costs (like GAAP changes) mentioned in the LEC Price Cap Order and codified in Rule 61.45(d).

Finally, Ad Hoc argues against exogenous treatment by suggesting that (p. 9) LECs have not shown lack of interference

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<sup>13</sup> Transmittal No. 2051, Order released May 6, 1992, 7 FCC Rcd 2906, para. 32.

with the orderly administration of the price cap system. Ad Hoc cites to the LEC Price Cap Reconsideration Order at para. 62, where the Commission stated:

"Our decision not to consider exogenous cost treatment of GAAP changes, including OPEB expenses, until the GAAP change becomes effective is one grounded in the orderly administration of our price cap system. The requirement ensures that we will not be called upon to render decisions prior to the time FASB has made a final ruling."

Again, in the instant case, the NTCs request exogenous treatment for the OPEB regulatory accounting change only for the time period that the change is effective. Thus, the Commission's price cap administration concern expressed in the LEC Price Cap Reconsideration Order is not applicable. See also Section II.B, *infra* discussing how exogenous treatment here will be in furtherance of the FCC's price cap policies.

In sum, under the FCC's price cap regime, since the SFAS 106 change has been mandated by the Commission to be reflected in regulatory accounting, exogenous treatment should be afforded to the extent there will be no double-counting in the price cap/GNP-PI mechanism.

B. Exogenous Treatment Of The OPEB Accounting Change Will Advance The FCC's Price Cap Policies

As we set out in our Direct Case (pp. 6-7), the central purpose of the Commission's price cap regulatory regime is to foster incentives for carriers to be more efficient and productive than a benchmark measure of cost changes.<sup>14</sup> An

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<sup>14</sup> See OIS para. 5 & n. 2.

important component of the price cap formula consists of exogenous costs, generally defined as those costs that are triggered by administrative, legislative or judicial action beyond the control of carriers: "these are costs that should result in an adjustment to the cap in order to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates."<sup>15</sup>

1. Risk/Reward Balance: Ad Hoc argues that (p. 16):

"Any expansion of the list of exogenous cost[s] impacts the delicate balance of risks and rewards upon which the price cap system is built. Each addition to the list incrementally reduces the risks carriers must balance against the higher financial rewards available under the price cap system, as well as the incentives for carriers to manage costs within their control."

Inasmuch as the Commission has held that exogenous costs should result in an adjustment to the cap in order to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates, it is clear that the purpose of exogenous costs is not solely to bring about downward adjustments. That purpose is also to allow for upward adjustments where a cost is proven to meet exogenous cost requirements. To date, the majority of exogenous costs in price cap filings have been downward adjustments resulting in rate decreases.<sup>16</sup> Fairness is served by permitting an upward

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<sup>15</sup> LEC Price Cap Order, para. 166; OIS para. 5.

<sup>16</sup> In the filing effective January 1, 1991 initiating price caps, price cap LECs' access rates were reduced by approximately \$342 million. In the 1991 Annual Filing, access rates for Price Cap LECs were reduced by approximately \$486 million and in the 1992 Annual Filing,

adjustment here.

Allowing exogenous treatment for a GAAP change like SFAS 106 is certainly not a "heads we win, tails you lose" proposition, as Ad Hoc<sup>17</sup> and MCI<sup>18</sup> would have the Commission believe. Some GAAP changes may increase revenue requirements, while others may decrease them. Since the FASB's GAAP changes are well-publicized and industry-wide, and are automatically incorporated into the FCC-prescribed regulatory USOA absent the Commission's contrary determination, there is no ability for carriers to "pick and choose" GAAP changes based upon rate effects.

2. Preservation of Incentives: It bears emphasis that the mandated, uncontrollable regulatory accounting change is the exogenous event here. Under the price cap system, as we implement SFAS 106, we will have every incentive to continue to be efficient and productive in managing the underlying OPEB expenses subject to the new accounting. See discussion infra in this section regarding the "windfall" argument.

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16 (Footnote Continued From Previous Page)

Tier 1 LECs and the National Exchange Carrier Association (NECA) filed access rate reductions of \$463 million. The Commission then ordered an additional \$32 million reduction in access rates for price cap LECs. For the NYNEX Telephone Companies specifically, the tariff revisions effective January 1, 1991 resulted in a \$48 million decrease in access rates. The 1991 Annual Filing resulted in a negative revenue effect of approximately \$68 million. The NTCs' 1992 Annual Filing resulted in a decrease of approximately \$24 million in access rates.

17 ETI Report 1-2.

18 p. 24.

3. Valid Cost Change: MCI mistakenly asserts that (p. 10) the implementation of SFAS 106 does not change the economic costs of providing interstate telecommunications services. MCI's argument is contrary to the FASB's expert judgment, following years of study and industry comment, that OPEBs should be booked as an accrued expense that recognizes these benefit costs as a form of deferred compensation earned by employees as they provide service to the employer.<sup>19</sup> The FCC implicitly accepted this economic recognition of OPEBs when it ordered SFAS 106 to be reflected in regulatory accounting.

Not only are OPEBs valid economic costs, but exogenous treatment would further the matching principle. As ratepayers benefit today from employees' services, those same ratepayers should also pay for the OPEBs earned by those employees that are accounted for as current expenses under SFAS 106.<sup>20</sup>

4. "Windfall" Arguments: Throughout all four opposition filings, there is a recurring allegation that exogenous treatment should not be granted (or strictly limited per the AT&T filing) to the price cap LECs because companies have total control over their own actuarial assumptions, and thus can somehow manipulate their SFAS 106 accruals to generate "windfall profits."<sup>21</sup>

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<sup>19</sup> See SFAS 106 Summary.

<sup>20</sup> To the same effect, the FCC allowed initial price cap rates to go into effect reflecting pension costs accrued pursuant to SFAS 87. See US WEST And NYNEX Requests To Implement New Pension Accounting For Calendar Year 1987, AAD 7-1572, Order released April 27, 1987, 2 FCC Rcd 2464.

<sup>21</sup> See, e.g., AT&T 24, Ad Hoc 13, 16 (asserting LECs would benefit now from proposing "gold-plated benefits.")

These assertions are simply false. The price cap LECs do not have unlimited freedom of choice in selecting actuarial assumptions regarding SFAS 106. The SFAS 106 standard itself mandates that companies utilize their best estimate of all factors which affect the calculation of the OPEB liability, including future medical trend rates, the discount rate, mortality and turnover factors, etc. All actuarial assumptions utilized by the NTCs in calculating SFAS 106 cost estimates (as well as our SFAS 87 pension costs) comply with both GAAP and generally accepted actuarial principles. Additionally, those assumptions and calculations must meet the standards for approval established by our enrolled actuary and those set by our external auditors.

The NTCs and the other price cap LECs cannot simply change actuarial assumptions after exogenous treatment is granted to generate windfall earnings. After adopting SFAS 106, we will continue to monitor the actual experience with respect to the various assumptions made (as we do for SFAS 87 assumptions), and will change an assumption only when changes in economic conditions are sufficient to clearly warrant it. One must remember that most of the key assumptions used to value the SFAS 106 liability are of a very long term nature (projected medical inflation rates, earnings on plan assets, mortality rates, etc.); thus these assumptions should not be changed simply on the basis of short term economic fluctuations.

Our opponents' "windfall" argument is unfounded also in light of the fact that OPEB benefits are part of a total compensation package that generally is determined through the

supply/demand process in labor markets. Specifically, the NTCs and other price cap LECs have a significant portion of total compensation costs determined through the collective bargaining process with union-represented employees. This process in turn is affected by total compensation packages for employees of comparable skills in the general economy. We could not make significant alterations to our benefit package without consideration of 1) the collective bargaining process;<sup>22</sup> 2) the promise made to retirees; and 3) the impact on our ability to attract and retain employees. As an article relied upon in the MCI Opposition states:

"Legal and practical considerations may make the benefits [OPEBs] a fairly fixed obligation. As a legal matter, the ability of employers to cancel or amend benefits is highly uncertain, owing to different precedents established in various circuits of the federal courts in interpreting the language of contracts and the intentions of relevant parties. More importantly, as a practical matter, concerns about ethics, labor relations (particularly in a unionized environment), and public relations impose constraints on the ability of employers to act unilaterally on this issue."<sup>23</sup>

The opposition parties' speculations about unilaterally cutting OPEBs to produce windfalls are totally unrealistic also in view of the sustained increases in medical benefits, growth in body of eligible employees, the political climate to protect workers, and accelerating competition in the

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22 Indeed, in 1989 the NTCs experienced a protracted and costly work stoppage over the central issue of a proposed reduction of medical benefits.

23 H. Fred Mittelstaedt and Mark Warshawsky, The Impact of Liabilities for Retiree Health Benefits on Share Prices, Federal Reserve Board Paper # 156, April 1991, p. 3.

NTCs' markets which would preclude the ability to raise rates to generate a "windfall."

In the final analysis, the price cap system will work as planned where we make our best estimate of OPEB expenses, and continue to become more efficient and productive with respect to all areas of costs, including OPEBs. To the extent OPEBs may be later associated with "low" or "high" earnings by price cap LECs, that would be part of the risk/reward balance of the price cap regime, and in any event the Commission has regulatory backstops in place. As we described in our Direct Case (pp. 22-23), the lower formula adjustment and the sharing zones<sup>24</sup> are designed to provide a backstop on low earnings to prevent unreasonably low rates, and to provide a cap on high earnings to prevent unreasonably high rates.

5. Low End Adjustment: MCI wrongly suggests that (pp. 23-24) instead of granting exogenous treatment for SFAS 106 implementation, the Commission should rely on the low end adjustment formula. MCI misapprehends the operation and purpose of the Commission's price cap mechanism.

As requested in the OIS (para. 11), our Direct Case commented upon (pp. 22-24) the low end adjustment formula. We pointed out that exogenous adjustments and low end adjustments are entirely independent of each other and serve different purposes. In short, exogenous cost changes are intended to

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<sup>24</sup> The sharing mechanism has three components: 1) a "no-sharing zone" for earnings between 10.25% and 12.25%; 2) a "50-50 sharing zone" for earnings between 12.25% and 16.25%; and 3) return to ratepayers of 100% of earnings over 16.25%. LEC Price Cap Order, paras. 123-25.



reflect costs not captured in the productivity or inflation factors; the low end adjustment is intended to afford relief to a carrier that, despite attempts to control costs, has not been able to prevent unreasonably low earnings.

Under the low end adjustment mechanism, if a LEC's earnings fall below 10.25% in a base year period, it is entitled to adjust its rates upward to a 10.25% target return, using the prior period as the baseline.<sup>25</sup>

The Commission has characterized the low end adjustment mechanism as a "backstop" serving the following purpose:

"The challenging productivity factor we have selected is designed to generate lower rates for customers while offering LEC's a fair opportunity to earn higher profits.... [I]t is difficult to determine a single, industry-wide productivity offset that will be perfectly accurate for the industry as a whole or for individual LECs or market conditions at a given time.... Individual LECs may experience significant variations from the industry productivity norm, not because of their own foresight and efforts but as a result of regional economic booms or recessions, among other factors. These possible sources of errors in the productivity offset support the adoption of a backstop program ... to adjust rates in the event that such unanticipated errors in the price cap formula occur.... A backstop mechanism can also serve to ensure that the plan fairly shares the risks and rewards of future productivity gains between the LECs and customers, even in the unpredictable and varying circumstances of future years."<sup>26</sup>

The low end adjustment mechanism "can also serve to ensure that application of the formula does not subject any price cap LEC to depressed earnings over an extended period of

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<sup>25</sup> LEC Price Cap Order, para. 127.

<sup>26</sup> Id. at paras. 120-21.

time that could impair such a LEC's ability to provide quality service to local subscribers."<sup>27</sup>

The FCC expressly designed the low end adjustment mechanism to achieve objectives wholly distinct from trying to reflect such a cost change as will be occasioned by SFAS 106 implementation. As SFAS 106 implementation is mandatory and beyond our control, an exogenous change is the price cap mechanism fashioned by the FCC for this type of item. The low end adjustment is intended to handle "particular LECs" whose productivity and earnings differ significantly from industry benchmark measures, usually as a result of temporary factors (e.g., "regional recession"). On the other hand, the SFAS 106 accounting change applies across the industry to price cap LECs and represents a permanent change. It is the required change in accounting method (from pay-as-you-go to accrual accounting for OPEB expenses) that will cause exogenous cost changes.

Moreover, if the FCC had intended the low end adjustment to address exogenous cost changes, the FCC would not have promulgated the exogenous cost component of the price cap formula and the Rule 61.45(d) list of presumptively exogenous items.

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<sup>27</sup> Id. at para. 121. See also *id.* at paras. 127, 147 and 10 ("lower end adjustment mechanism ... ensure[s] that the plan automatically corrects itself should our selection of a productivity factor for the industry turn out to be too high for a given company.")

6. Differences Between OPEB Accounting Change  
And Other Items Denied Exogenous Treatment:

Our opponents inappropriately try to liken OPEBs to certain other items (such as depreciation, equal access and general business taxes) denied exogenous treatment by the Commission.

-- Depreciation: In arguing against exogenous treatment of SFAS 106 implementation, Ad Hoc relies upon (p. 10 & n. 21) the FCC's denial of exogenous treatment of depreciation.<sup>28</sup> In the AT&T Price Cap Order cited by Ad Hoc,<sup>29</sup> the FCC took the view that AT&T has control over decisions such as: 1) when to replace older, maintenance-intensive facilities with expensive but low-maintenance new plant; 2) when to defer new investment; 3) how to defer new investment; and 4) how to achieve the ideal mix of capital and labor. The Commission noted that the carrier should bear the risks/rewards of its decisions if there is to be an incentive for the carrier to be more efficient and productive; and that if the FCC guarantees recovery of depreciation expense which is an expense involved in all of the above decisions, then it "distorts the process and risks destroying the incentives it wished to create."

The cost associated with the accounting change for OPEBs cannot properly be compared to depreciation expenses. With OPEBs, the NTCs are asking for exogenous treatment of an

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<sup>28</sup> See also AT&T 18-19 (alleging similarities between OPEBs and depreciation).

<sup>29</sup> 4 FCC Rcd 2873 (1989), para. 291.

additional expense imposed as a result of a regulatory accounting change not under our control, in contrast to the FCC's perception of depreciation as being under the carriers' control.<sup>30</sup> If the FCC were to mandate a USOA/GAAP accounting change for depreciation, or effectuate policies actively affecting plant lives and retirement, then those changes would be eligible for exogenous treatment.

-- Equal Access: Ad Hoc suggests that (pp. 14-18) SFAS 106 costs should not be treated as exogenous for the same reasons that the Commission denied exogenous treatment of equal access costs.<sup>31</sup> Ad Hoc asserts that equal access costs were denied exogenous treatment because they may be manipulated, are difficult to assess, and such treatment may provide a disincentive to improving efficiency.

Ad Hoc's comparison of equal access costs to OPEB costs is inappropriate. In the LEC Price Cap Order, the FCC stated that (para. 180):

"While it is true that under rate of return regulation, the Commission allowed carriers to recover equal access costs, the necessity for this support, at least for the largest LECs, has greatly diminished. For the largest carriers, conversion has been largely completed, and its associated costs are embedded in existing rates. This being the case, there is little need to encourage these LECs to convert to equal access by treating the costs of their conversions as exogenous."<sup>32</sup>

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<sup>30</sup> To the same effect, AT&T has significant control and negotiating power with respect to international accounting rates, unlike the price cap LECs' lack of control over the OPEB accounting change. See AT&T 19 n. 1.

<sup>31</sup> See also AT&T 23 (referring to difficulty of calculating equal access costs).

<sup>32</sup> See also LEC Price Cap Reconsideration Order, para. 64.

Therefore, one primary reason for the disallowance of equal access costs as exogenous was the fact that a large amount of equal access costs had already been recovered under rate of return regulation, thereby diminishing the "necessity for support", and some equal access costs were embedded in existing rates. This is not a factor in exogenous treatment of incremental OPEB costs from SFAS 106 since most of those costs have not yet been recovered. While some LECs accrued certain OPEB expenses prior to the initiation of price caps, in many cases (such as the NTCs) LECs' existing rates reflect only pay-as-you-go accounting for OPEBs. And, in either case, the requested exogenous adjustment is only for the incremental increase in OPEB costs due to the mandatory adoption of SFAS 106 (i.e., above existing cost levels).

Moreover, in expressing concern that allowing equal access costs to be exogenous would provide a disincentive to manage those costs in an efficient manner, the Commission drew a distinction between equal access costs and other costs that are treated as exogenous, such as cost changes derived from a change in regulation.<sup>33</sup> In the case of OPEBs, the change sought is due to a change in regulation, i.e., the required change in accounting method due to SFAS 106. Therefore, under the Commission's own definition there is a distinction between equal access and OPEBs.<sup>34</sup>

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<sup>33</sup> LEC Price Cap Reconsideration Order, para. 31.

<sup>34</sup> Relative to the Commission's concern that LECs could "willfully or inadvertently shift switched access costs

--General Business Taxes: Ad Hoc (at pp. 8-9) tries to draw a parallel between OPEBs and general business taxes, stating: "Costs incurred by the general business population or segments thereof, the Commission has held, are not properly classified as exogenous." In support, Ad Hoc cites an Order by the Deputy Chief (Policy), FCC Common Carrier Bureau in Bell Atlantic Telephone Companies Tariff F.C.C. No. 1.<sup>35</sup> Ad Hoc's argument is mistaken. In that Bell Atlantic case, the Bureau denied Bell Atlantic exogenous treatment of changes in two Pennsylvania general business taxes (Corporate Net Income Tax, Capital Stock/Franchise Tax). The Bureau reasoned: Bell Atlantic used an incorrect methodology to remove a double-count from the GNP-PI (paras. 13-14), and:

"in future rate periods ... tax changes in other states could produce a rising GNP-PI less inflation factor that is increasing faster than Bell Atlantic's own costs. There is no mechanism in the price cap formula to force Bell Atlantic in those years to tailor the index to match its lower costs. As a result, the net effect of Bell Atlantic's plan to treat general tax increases as exogenous costs over time produces a systematic bias against ratepayers."<sup>36</sup>

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34 (Footnote Continued From Previous Page)

into the equal access category" if exogenous treatment for equal access was approved, OPEB costs are verifiable specific costs for benefits and are not analogous to network expenditures that may be used for multiple services.

35 Transmittal No. 473, 7 FCC Rcd 1486 (released February 10, 1992).

36 Id. at para. 14.

The present SFAS 106 implementation cost matter is readily distinguishable from the Pennsylvania general business tax matter. The SFAS 106 OPEB accounting change applies throughout the telecommunications industry. GAAP changes issued by the FASB and adopted by the FCC for regulatory purposes are quite visible, well-publicized and may increase or decrease costs. Since carriers do not have the ability to selectively apply the GAAP changes, there is no "systematic bias against ratepayers." And finally, while the FCC has stated that general business taxes are presumptively endogenous,<sup>37</sup> GAAP changes are on the Commission's specific list of presumptively exogenous items.<sup>38</sup>

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In sum, notwithstanding the opposition filings, exogenous treatment of SFAS 106 implementation costs will be entirely consistent with, and indeed will further the Commission's price cap policies.

### III. THE SFAS 106 IMPLEMENTATION COSTS FOR EXOGENOUS RECOVERY ARE NOT DOUBLE-COUNTED UNDER PRICE CAPS

#### A. The Godwins Study Is Sound

As demonstrated in the Godwins study, relied upon in our Direct Case, about 84.8% of the additional costs from the SFAS 106 OPEB accounting change will be unrecovered, and should

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<sup>37</sup> Id. at para. 10.

<sup>38</sup> 47 C.F.R. Section 61.45(d).

be treated as exogenous. Our opponents' various criticisms of the Godwins study are effectively refuted in the attached Supplemental Report prepared by Godwins. Among other things, Godwins shows the unsoundness of AT&T's alternative proposal (pp. i-ii, 14) to subtract the expected rate of change of the GNP-PI from the health care inflation component of the SFAS 106 accrual.

B. There Is No Double-Counting Of SFAS 106 Implementation Costs In The Rate of Return Prescription Reflected In Initial Price Cap Rates

Ad Hoc, ICA and MCI wrongly claim that the current interstate access rate of return prescribed by the FCC contemplated the costs associated with SFAS 106, and to afford these costs exogenous treatment would result in double recovery.

Not only did the FCC not consider the costs of SFAS 106 during the rate of return prescription process, but these costs were not known to the FCC or to anyone else at the time. Nowhere in the material submitted to the FCC during the rate of return prescription process is SFAS 106 mentioned, nor does the FCC's rate of return prescription Order reference SFAS 106.<sup>39</sup> Hence, any claim that the rate of return prescribed by the FCC already considered the impact of FASB 106 is unfounded and should be rejected.

Both Ad Hoc and ICA rely on the ETI Report which asserts that (p. 2) "the Commission should fairly conclude that

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<sup>39</sup> Authorized Rate Of Return For Interstate Services Of Local Exchange Carriers, Order released December 7, 1990, 5 FCC Rcd 7507 (1990 Rate of Return Prescription Order).



FAS 106 effects already are discounted to some degree in the existing nationwide average rate of return prescribed for all carriers." ETI further notes that (p. 11) "the FCC's represcription of the industry-wide rate of return relied upon Institutional Brokers Estimate Service (IBES) data on dividends, earnings and stock prices as part of the discounted cash flow analysis used to establish the prescribed return on equity"; and ETI seeks to place on the price cap LECs the burden of proving that "the ROR did not fully discount future [OPEB] costs for LECs and other firms deemed comparable by the FCC's prescription process."<sup>40</sup>

Absent some clairvoyant powers, there is no way that the prices of any stock considered by the FCC in its rate of return prescription process could have been affected by SFAS 106. The simple fact of the matter was that the latest data relied upon by the FCC in its rate of return prescription was from January - July 1990, a period that began a full year before the announcement of SFAS 106.

While it is true that the accounting treatment of nonpension postretirement benefits had been publicly discussed prior to the formal announcement of SFAS 106, there is absolutely no evidence -- on this record or elsewhere -- that the stock market in any way discounted its impact. Indeed, the following quotation from the first page of an April 1989 article cited by MCI (p. 15 n. 23) is instructive:

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<sup>40</sup> ETI Report 12.